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CITATIONS

In the Supreme Court of the United States

OCTOBER TERM, 1962

No. 476

BENJAMIN BRAUNSTEIN, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Tax Court (A. 184–281)[1] is reported at 36 T.C. 22. The opinion of the court of appeals (R. 21–39) is reported at 305 F. 2d 949.

JURISDICTION

The judgments of the court of appeals were entered on July 6, 1962 (R. 39–41). The petition for a writ of certiorari was filed on October 1, 1962, and was

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[1] "A." refers to the appendix to petitioners' brief in the court of appeals, of which nine copies were filed with the petition for certiorari. Because of its length and the irrelevancy, in view of the limited grant of certiorari, of many of its findings, the Tax Court's opinion was not reprinted in the record in this Court. The "A." references in this brief are solely to that opinion.

granted on December 10, 1962 (R. 42). The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

QUESTION PRESENTED

Section 117(m) of the Internal Revenue Code of 1939 provides that, if stockholders use a corporation to construct property and then, as planned, promptly sell their stock in order to realize in the form of stock proceeds the "gain attributable to such property," their gain is to be taxed as ordinary income. The question presented is whether the application of that provision is dependent upon a finding in each case that there was no other way for the stockholders to convert the values created by the construction into capital gain.

STATUTE AND REGULATIONS INVOLVED

Section 117(m) of the Internal Revenue Code of 1939 and § 29.117-11 of Treasury Regulations 111 (1939 Code) are set forth in part at pp. 39-48, *infra*.

STATEMENT

Petitioners Benjamin and Harry Neisloss are builders; petitioner Braunstein, an architect. The three petitioners[2] became associated in 1938 and thereafter joined in a series of construction ventures, usually through corporations the stock of which they owned equally (A. 186-187).

In February 1948, the petitioners obtained a commitment from the Federal Housing Administration, under § 608 of the National Housing Act, to insure

[2] Their wives are parties only by virtue of the filing of joint returns.

mortgage loans for the construction of a multiple-dwelling garden-type apartment project. The project was to be carried out by two corporations, Springfield Development Company, Inc. (480 apartment units), and Hill Development Company, Inc. (224 units). (A. 189–190.) The transactions involving the two corporations were identical in all aspects material here, however, and for simplicity we will confine the statement of facts, and the discussion in the Argument, to those involving Springfield.

The FHA[3] estimated the cost of the Springfield project as follows (A. 192–195, 198):

On-site construction costs	$4,002,959	
Builder's fee (5%)	200,148	
Architect's fee (5%)	210,155	
Subtotal		$4,413,262
Off-site construction costs (sewers, streets, etc.)	$101,443	
Subtotal		$4,514,705
Financing fees, carrying charges during construction, legal and organizational expense	$270,442	
Total		4,785,147

Based on those estimates, the FHA agreed to insure a mortgage in the amount of $4,174,800, an amount basically determined[4] as 90% of the total estimated costs exclusive of off-site construction ($4,785,147 less $101,443, or $4,683,704) (A. 194).

Springfield was organized on March 31, 1948, to carry out the approved project. Ten shares of common stock were issued to each of the three petitioners

[3] The estimates made by petitioners in their application for loan insurance were somewhat higher (A. 191).

[4] A discrepancy of some $40,000 is attributable to an adjustment required because of the lack of fee ownership of the land (see A. 194).

for $1 per share, for a total capital contribution by them of $30.[5] (A. 199.)

To perform the construction work, the petitioners formed, with equal shares, a partnership known as the N.B. Construction Company.[6] The partnership originally executed a contract to perform all of the on-site construction work for the corporation for a cash price of $4,002,959 (*i.e.,* the FHA's estimated cost) plus a 5% builder's fee to be paid in stock (A. 201–202). Petitioner Braunstein similarly contracted to perform the architectural services for a 5% fee to be paid in stock (A. 203). The builder's and architect's fees were, however, contemporaneously waived and it was never intended that they should be paid (A. 202–203). The formal lump-sum construction contract was apparently also never meant to be enforced, and the partnership in fact performed the work on a cost-reimbursement basis. The partnership similarly performed the off-site work, for which no formal contract was ever made, on a cost basis (A. 204, 205). The total cost to the partnership of both the on-site and the off-site construction work was $3,807,908, and it charged only that amount to the corporation (A. 222). Since it charged only for its out-of-pocket costs, the partnership reported no taxable income from the construction (A. 205).

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[5] Pursuant to FHA regulations, 100 shares of $1 par value preferred stock were issued to the FHA for $100 in cash (A. 199).

[6] The work was initially to be done by a corporation, but the partnership took over almost immediately (A. 201–202, 204–205).

The work performed by the partnership (including the services of petitioner Braunstein as the nominal architect) for a total price of $3,807,908 had been estimated by the FHA to cost $4,514,705,[7] or $706,797 more than the actual cost. The nonpayment of the estimated builder's ($200,148) and architect's ($210,155) fees accounted for $410,303 of the savings. The additional savings were attributable largely to the fact that the partnership did not (as the estimates had assumed the builder would) contract out the carpentry, plumbing, and heating work but performed the work itself, thereby effectively eliminating from the costs the subcontractors', as well as the builder's and architect's, normal mark-up (A. 227–228).[8]

Besides the savings of $706,797 realized by the corporation in its dealings with the partnership, the amounts spent by the corporation for carrying charges during construction (interest, taxes, insurance), financing costs (FHA fees for mortgage insurance and inspection, etc.; title and recording fees; etc.), and for legal and organization expenses turned out to be $9,342 less than estimated ($261,100 instead of $270,442) (A. 193–194, 224).

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[7] Direct on-site construction costs, $4,002,959; builder's and architect's fees, $410,303; off-site construction, $101,443 (A. 192–195, 198).

[8] For both Springfield *and* Hill, the savings on carpentry were estimated at $80,000 and on plumbing and heating, at $85,000 (A. 227). Declining lumber prices also produced an unexpected savings of $50,000 for the two projects (A. 228). Since the partnership's construction costs were allocated about 68% to Springfield ($3,807,908) and 32% to Hill ($1,757,581), the savings were presumably realized in the same proportion (A. 222).

In all, the total estimated cost for construction, financing and carrying costs was $4,785,147 while the cost actually incurred was $4,069,008 (A. 224), effecting a total savings over the estimates of $716,139. The amounts actually expended ($4,069,008) were in fact less by $105,792 than the proceeds of the insured mortgage loan ($4,174,800), with the construction thus being financed entirely from the loan proceeds.

Construction of the buildings, which had begun in April 1948, was completed on varying dates from September 1948 to June 1949, and by September 1, 1949, all units were occupied (A. 204, 206–207).

On June 8, 1950, the petitioners entered into an agreement to sell their 30 shares of common stock in Springfield to one Penzell. The agreement provided, in effect, that the corporation would first make a distribution of $410,000 to the petitioners and that they would then convey the stock to the buyers for a further payment of $273,500. The agreement was executed substantially according to its terms. On June 30, 1950, the board of directors of Springfield increased the book value of the buildings by $750,000 (to accord approximately with the FHA's original estimate) and declared a dividend of $410,000 on the common stock. The dividend was paid to petitioners on August 25, 1950 (A. 243–245).[3] After several postponements for the convenience of the buyers, the stock was transferred to them on November 13, 1950, for the agreed-upon price (with minor adjustments not relevant here) (A. 249-250).

[3] Payment of the dividend was effected primarily by the corporation's cancellation of a debt owed it by the partnership for advances (A. 246–247).

We agree with petitioners (Br. 39, n. 8) that the corporation's distribution of $410,000 followed by the sale of the stock for $273,500 was substantially equivalent in consequence, under the circumstances of this case, to an outright sale of the stock for $683,500 paid directly by the buyers.[10] In the discussion in this brief, therefore, we will for simplicity ignore the separate character of the distribution and treat the entire $683,350 as having been received by the petitioners directly from the buyers.

Each petitioner reported his one-third share of the proceeds, less his $10 basis and expenses of sale, as a long-term capital gain.[11] The Commissioner as-

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[10] Since the corporation had no earnings or profits, there is no question of dividend treatment, and the distribution would therefore be treated for tax purposes as an amount received upon sale or exchange of the stock. That is true both generally (see § 115(d)) and for purposes of the collapsible-corporations provisions involved here (see § 117(m)(1); Treas. Regs. 111, § 29.117-11(a), *infra*, p. 41).

[11] For the second corporation, the Hill Development Company, Inc., the estimated and actual costs were (A. 209-214, 222, 226):

	Estimated	*Actual*
1. On-site construction	$1,848,176	
2. Builder's fee (5%)	92,409	
3. Architect's fee (5%)	97,029	
4. Off-site construction	47,339	
5. Subtotal	$2,084,953	$1,757,581
6. Financing, etc	124,486	115,253
7. Total	$2,209,439	$1,872,834

The difference between the estimates and the actual cost for the work performed by the petitioners (line 5) was $327,372. From their Hill stock, which they similarly sold to Penzell, petitioners realized a total of $271,500, of which $145,000 was a distribution from the corporation and $126,500 was paid directly by the buyers (A. 243-245). They treated their gain in the same way as that from the Springfield stock.

d a deficiency treating the gain as ordinary in- (A. 250–252). The Tax Court upheld the de- ncy, holding that Springfield was a "collapsible oration" as defined in § 117(m)(2) of the Internal enue Code of 1939 and that petitioners' gain was rdingly taxable as ordinary income under § 117 (1) (A. 184–281). The decision was reviewed by ull Tax Court, with Judge Kern dissenting. The rt of Appeals for the Second Circuit affirmed 21–39).

SUMMARY OF ARGUMENT

a corporation is formed for the "manufacture, truction, or production of property" and the kholders, through a quick sale of their stock ned for that purpose, realize gain more than 70% hich is "attributable to the property so manufac- d, constructed, or produced," the gain is, under (m) of the 1939 Code, taxable as ordinary in- . It is not open to question here that the peti- ers' sale was planned, and it is agreed that the zed value of their stock reflected but the excess ne value of the buildings over their construction To that extent, it is undisputed that the gain sought and realized by petitioners was "attrib- le" to the buildings. If that is the sole meaning ne "gain attributable to" phrase, the gain was tax- as ordinary income.

espite the natural reading of "gain attributable as looking only to the source or cause of the gain d the essential function it performs given that

meaning), petitioners contend that it ought to be so read as to limit the application of the statute to gains which would have been taxable as ordinary income had the stockholders constructed and sold the buildings without the use of a corporation. Such a reading is required, they say, to confine the statute to its evident purpose—namely, to prevent the conversion of ordinary income into capital gain.

However freely the question of interpretation is approached, the words of the statute are quite incapable of carrying the meaning petitioners would give them. Moreover, the implied limitation petitioners would read into the statute conflicts with the regulations; is contrary to the settled assumptions of commentators, litigants, and the courts for many years; and would make a nullity of an express, and much narrower, limitation later added by Congress.

In any event, no limitation need be supplied to confine the statute to its admitted purpose of preventing the "conversion" of ordinary income into capital gain. The very terms of the statute limit its application to gain which, although in the form of stock proceeds, represents a realization of values created by the "manufacture, construction or production of property." Each of those is a value-creating process, the fruits of which obviously ought to be, and normally are, taxed as ordinary income.

In this case, the conversion of ordinary income is blatant. Petitioners, having contributed $30 for their stock, were able two years later to dispose of it for

$683,500 for only one reason: by charging the corporation nothing for architectural, general contracting, and subcontracting services estimated to cost over $700,000, they had created for the corporation buildings worth $683,500 more than their actual cost. In short, petitioners contributed their services to create a valuable property for the corporation and then realized upon that value by selling their stock. If compensation for services be the prime example of ordinary income, petitioners' gain—simply a realization in another form of the compensation they should have been paid for their construction services—is a prime example of converted ordinary income.

Petitioners assert, however, that they could successfully have converted the value of their services into capital gain by constructing and selling the buildings as individuals. Assuming that to be so, it proves only that loopholes remain, not that the Court should reopen the one Congress closed. Nothing suggests that the application of § 117(m) was meant to depend upon how some alternative transaction would be taxed, much less the particular alternative tendered by petitioners. Had the corporation paid petitioners for their services, the gain would undeniably have been taxed as ordinary income, and petitioners give no reason why that alternative should be any less determinative of the "true" nature of the gain than the one they offer.

ARGUMENT

SECTION 117(m) OF THE INTERNAL REVENUE CODE OF 1939, MAKING GAIN FROM THE SALE OF STOCK IN A "COLLAPSIBLE CORPORATION" TAXABLE AS ORDINARY INCOME, IS SELF-CONTAINED; ITS APPLICATION IS NOT DEPENDENT UPON A DETERMINATION THAT THERE WAS NO OTHER WAY FOR THE TAXPAYER TO HAVE CONVERTED HIS PROFITS FROM CONSTRUCTION INTO CAPITAL GAIN

I

THE STATUTE IS APPLICABLE BY ITS TERMS

Section 117(m)(2)(A) of the Internal Revenue Code of 1939[12] defines a "collapsible corporation" as:

> * * * a corporation formed or availed of principally for the manufacture, construction, or production of property * * * with a view to—
>
> (i) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation * * * of a substantial part of the net income to be derived from such property, and
>
> (ii) the realization by such shareholders of gain attributable to such property.

If a corporation is collapsible, then any gain realized by a holder of more than 10% of the stock from a stock sale or corporate distribution within three years of the completion of the property is to be taxed as

[12] Except as otherwise indicated, all section references are to the Internal Revenue Code of 1939 as amended by the Revenue Act of 1950, 64 Stat. 932, the form in which it stood on the relevant dates. The later amendments are indicated at p. 21, n. 21, *infra*.

ordinary income (§ 117(m) (1) and (3)), except that—

> this subsection shall not apply to the gain recognized [by a shareholder] during a taxable year unless more than 70 per centum of such gain is attributable to the property so manufactured, constructed, or produced; * * * [§ 117(m)(3)(B)].

It is admitted that each petitioner owned more than 10% of the stock; that their gains were realized within three years; and that the corporation was formed "principally for the * * * construction * * * of property." It is also not open to question that, during the construction of the buildings, the petitioners contemplated (*i.e.,* had "a view to") selling their stock shortly after construction was completed (*i.e.,* "prior to the realization by the corporation * * * of a substantial part of the net income to be derived from such property"). The Tax Court so found; the court of appeals affirmed the finding; and this Court, limiting the grant of certiorari (R. 42), declined to review the question.

The controversy, so far as it relates to any words in the statute, concerns solely the "gain attributable to" phrase, which appears, with admittedly the same meaning (Br. 77–78), both in the definition of a collapsible corporation (§ 117(m)(2)(A)(ii)) and in the limitation on stockholder taxability (§ 117(m)(3)(B)). A corporation is not collapsible unless the object of the stockholders' planned sale is to realize "gain attributable to [the property manufactured, constructed, or produced]", and a stockholder is not

taxable unless more than 70% of the gain he actually realizes is so attributable. Thus, the only gain of a shareholder that the statute ever seeks to tax as ordinary income[13] is gain that is attributable to, or a realization upon the value of, property which the corporation has created by manufacture, construction, or production, and the stockholders must both seek and realize such gain for the statute to apply.

Here, there is no dispute that the gain the petitioners realized is the gain they sought. The question, therefore, goes not to the state of mind of the petitioners but to the proper characterization of the gain they actually realized. If that gain was, in the words of the stockholder-taxability limitation, "attributable to the property so manufactured, constructed, or produced," it equally follows, since the gain realized was that anticipated, that the corporation was collapsible. We may in this case, therefore, treat the two requirements as one and focus directly upon the objective character of the gain.[14]

[13] The 70% rule of § 117(m)(3)(B), of course, requires an all-or-nothing treatment, but the statute's target is not less clear for that.

[14] The primary reason for the two separate requirements is that the definition establishes the characterization of the corporation for all purposes, while the 70% rule is separately applied to each year's gains of a stockholder, a difference that could be important in a case involving a series of corporate distributions covering more than one taxable year. However, even where a disposition of the stockholders' entire interest in the corporation occurs, as planned, in a single year, it is at least a theoretical possibility that the sale could have been planned in anticipation of realizing a gain attributable to some

Nor is there any dispute in this case that more than 70% of the $683,500 gain realized by the stockholders was generated by the construction of the buildings, in the sense that it was the excess of the value of the buildings over their cost (and hence over the mortgage indebtedness to which they were subject) that caused their equity in the corporation to be worth $683,500 despite a paid-in capital of only $30. Thus, if it is only that causal relationship that is implied by the phrase, it is undisputed that the petitioners' gain (both as anticipated and realized) was "gain attributable to" the buildings the corporation was availed of to construct.

The sole question in the application of the statute, then, is that raised by petitioners' contention that the function of the "gain attributable to" phrase is not to identify merely the source of the gain—what caused the stock to increase in value—but to make a distinction based on the underlying nature of the gain. As they put it, the question is whether the gain realized is a conversion of what would otherwise have been ordinary income. Actually, as will later appear, the test they would read into the phrase is much more complicated and particularized than that, for they would make determinative of whether there is such a "conversion" what the tax consequences would have been of one particular alternative way (among the

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other expected event but actually produce, failing the event, only a minor gain attributable to the interim production. But whatever the possible difference in other cases, here there is no claim of such a disparity between anticipation and realization and the two requirements become one.

several possible) in which the venture might have been conducted. Specifically, they say that the determinant of § 117(m)'s applicability is how they would have been taxed had they constructed and sold the buildings in their individual capacities without the use of a corporation. If by that means they could have successfully realized their profits from the construction as capital gain, then their gain from the sale of the stock is not, they say, the *kind* of "gain attributable to [the] property" that is contemplated by that phrase.

We need not belabor the textual difficulties in making the words of the statute mean what petitioners would have them mean. Not only does "attributable to" literally refer only to what caused or generated the gain, but the limitation performs an obviously indispensable function given its natural meaning. The gain realized (and anticipated) by stockholders upon the sale of their stock in, say, a manufacturing corporation could be caused by many things other than the values added by manufacturing to the specific manufactured items on hand or in process at the time of sale. The increased value of the stock could reflect, for example, an increase in the value of the corporation's fixed assets (caused, say, by an influx of new industry into the area), an increased demand for its product, or even such an extraneous factor as the discovery of a claim for treble damages for an antitrust violation. The possible causes are infinite, and to confine § 117(m) to its intended scope it was plainly necessary to limit its application to gain that is "attributable to" the specific property the

corporation was availed of to manufacture, construct, or produce. It is only the manufacturing, construction, or production profits that the statute seeks to reach, and the "gain attributable to" phrase, given its literal meaning, is indispensable so to limit it. Nor can petitioners avoid the difficulty by retaining the natural meaning of "attributable to" and making the single word "gain" do the work of supplying an additional limitation. Not only is the word generally used throughout the section, as elsewhere in the Code, to denote merely the excess of proceeds over cost or basis, but it is necessarily in that sense that it is used in the 70% provision in direct association with the "attributable to" limitation.[15]

In fairness to petitioners, we should acknowledge that, apart from a few passing assertions which are never developed, they do not really pretend that the language of the statute can conveniently, or even with considerable straining, be made to hold the meaning that they would give it. Ultimately, their argument, though perhaps less candidly stated, is the same as that adopted by the Fifth Circuit in the conflicting decision on which they rely, *United States* v. *Ivey*, 294 F. 2d 799, rehearing denied with opinion, 303 F. 2d 109—namely, that, while there is no language in the statute to suggest it, an implied exception should be read into the statute to prevent allegedly absurd results and to give effect to Congress' under-

[15] That provision exempts a stockholder's total "gain" (necessarily, proceeds less basis) if less than 70% of "such gain" is "attributable to" the constructed property.

lying purpose. As the flavor of their brief as a whole makes evident, petitioners offer the "gain attributable to" phrase simply as the most convenient point at which to read into the statute—or as the most convenient "hook" on which to hang—an implied limitation which they contend must be made to make "sense" out of the statute.[16]

We will in the next Point meet petitioners on their own terms and demonstrate that not only does the statute as written fully carry out its basic purpose—which we agree is to prevent a conversion of ordinary income into capital gain—but that this case presents a classic example of the very kind of ordinary-income "conversion" at which the statute was aimed. Before so demonstrating, however, we will show that the petitioners' plea for a judicial, rather than legislative, rescue would have to be denied even if it were true that the statute as written produces results seemingly at odds with Congress' apparent purpose.

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[16] By pin-pointing the "gain attributable to" phrase as the situs of their implied limitation, petitioners offer a considerable improvement, we must acknowledge, over the Fifth Circuit's creation of an exception at large. Under the *Ivey* approach, the mechanics of the statute are abandoned entirely, with the court simply looking through the corporate form and making its own apportionment of the gain into that taxable as ordinary income and that taxable as capital gain. Petitioners, though not acknowledging their departure from the Fifth Circuit, understandably eschew such a total destruction of the statutory scheme. By choosing the "gain attributable to" phrase as the place in the statutory structure at which to locate the implied limitation, they at least preserve much of the mechanical operation of the statute, in particular the all-or-nothing operation of the 70% limitation (see Br. 76-78).

We of course agree with the general propositions proved by petitioners at such remarkable length: that statutory language should be read—indeed, even strained to some degree—to avoid absurd results, to carry out the discovered purposes of Congress, and in general, in an effort to produce a rational, sensible structure. Yet it must equally be acknowledged that there are limits to "interpretation." And what petitioners ask is not "interpretation" nor even "substitution"; it is the addition, out of whole cloth, of a highly specific and complex set of standards by which to determine the application of the statute.

It is true, as petitioners point out, that there are some words in the Code, found primarily in the broad provisions creating the basic framework of the tax system—such as "income" (§ 22(a)), "ordinary and necessary" (§ 23(a)), "gift" (§ 22(b)(3)), or "property" (§ 117(a))—that perforce can be given meaning only through judicial exegesis bringing to bear rather general notions of underlying statutory policy and the needs of a rational and workable tax structure. But as Judge Learned Hand observed, "as the articulation of a statute increases, the room for interpretation must contract." *Helvering* v. *Gregory*, 69 F. 2d 809, 810 (C.A. 2), affirmed, 293 U.S. 465. And in a statute articulated in such great detail as § 117(m), with its elaborate definitions and enumeration of explicit exceptions and limitations, there is no room for the kind of extensive rewriting that petitioners seek.

Nor does the statute arrive here newborn. It was enacted in 1950, and an intricate and complicated set of regulations interpreting it has been in force since 1953. Petitioners make no claim that their reading can be reconciled with the regulations, and of course it cannot.[17] Even were the statute ambiguous, as it is not, the regulations would control. *E.g., Commissioner* v. *South Texas Co.,* 333 U.S. 496, 501; *Helvering* v. *Wilshire Oil Co.,* 308 U.S. 90, 103. The statute has, moreover, been extensively litigated, with the great bulk of the cases[18] involving corporations formed, like Springfield, to construct apartment-house projects financed with FHA-insured loans. Yet not until 1961, when the Fifth Circuit's decision in *Ivey* was announced, was it ever suggested that the statute

[17] See, *e.g.*, Treas. Regs. 111, § 29.117-11(c)(3), which defines "gain attributable to the property" as simply "the excess of the recognized gain of the shareholder during the taxable year * * * over the recognized gain which the shareholder would have if the property had not been manufactured, constructed [or] produced." See also § 29.117-11(e), Example (1), giving as an example of a collapsible corporation the very kind of FHA-financed construction project involved here. Those provisions were first added to Regulations 111 by T.D. 5999, 1953-1 Cum. Bull. 187.

Treas. Regs. 118 (1939 Code), § 39.117(m)-1 (c)(3)(ii) and (e) (Ex. 1), and Regs. (1954 Code), §§ 1.341-4(c)(2), 1.341-5(d) (Ex. 1), are substantially the same.

[18] See, *e.g.*, *Glickman* v. *Commissioner*, 256 F. 2d 108 (C.A. 2); *Hartman* v. *Commissioner*, 296 F. 2d 726 (C.A. 2); *Mintz* v. *Commissioner*, 284 F. 2d 554 (C.A. 2); *Abbott* v. *Commissioner*, 258 F. 2d 537 (C.A. 3); *August* v. *Commissioner*, 267 F. 2d 829 (C.A. 3); *Burge* v. *Commissioner*, 253 F. 2d 765 (C.A. 4); *Spangler* v. *Commissioner* 278 F. 2d 665 (C.A. 4), certiorari denied, 364 U.S. 825; *Pomponio* v. *Commissioner*, 288 F. 2d 827 (C.A. 4); *Payne* v. *Commissioner*, 268 F. 2d 617 (C.A. 5); *Jacobson* v. *Commissioner*, 281 F. 2d 703 (C.A. 3).

was susceptible to an interpretation avoiding its application to such transactions.[19] The commentators, too, shared the universal assumption of the courts and litigants that the statute did not permit of interpretive relief even if it should operate, in a given case, to reach what would otherwise have been capital gain.[20] Thus, it is not only the words of the statute, but also the regulations and the established understanding of the courts and the tax bar, that petitioners must overcome.

If the obstacles are not already enough, there remains the fact that the collapsible-corporation provi-

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[19] Perhaps credit for the suggestion should go to the 1960 district court decision in *Honaker Drilling, Inc.* v. *Koehler*, 190 F. Supp. 287 (D. Kan.).

[20] Mertens, Federal Income Taxation, Code Commentary, § 341(b)(3):1; 3B Mertens, Federal Income Taxation, § 22.64 p. 271; DeWind and Anthoine, *Collapsible Corporations*, 56 Col. L. Rev. 475, 487, 508–509; Bittker, Federal Income Taxation of Corporations and Shareholders, pp. 309–310 (1959); Anthoine, *Federal Tax Legislation of 1958*, 58 Col. L. Rev. 1146, 1175, 1178 (1958); Axelrad, *Collapsible Corporations and Partnerships*, 1960 U. of So. Calif. Tax Inst. 269, 295; Seidman, *"Collapsible" Corporations—Applicable to Real Estate Transactions*, 15 Tax. L. Rev. 121, 132–135 (1959); Modrall, *Collapsible Corporations and Subsection (e)*, 37 Taxes 895, 897 (1959); Axelrad, *Recent Developments in Collapsible Corporations*, 36 Taxes 893, 916 (1958).

Comment after the *Irey* decision has been uniformly critical of the decision. Turner, *Judicial Trend Is Limiting Restrictions On Collapsible Corporations*, The Journal of Taxation (June, 1962), pp. 322, 327; Hewitt and Randerson, *Shareholder's Capital Gains Status No. § 341 Defense; CA-2 Conflicts With Irey*, The Journal of Taxation, pp. 194–195 (October, 1962); Ruecker, *Collapsible Dangers Can Be Avoided Despite Uncertainties; Cert Granted In Braunstein*, The Journal of Taxation, pp. 77, 80 (February, 1963).

sions have been the subject of continuous legislative study and revision since their adoption.[21] And in the 1958 amendments, Congress finally responded to claims, like petitioners', that the provision ought not apply to certain circumstances in which the gain might, by some other means, have been realized as capital gain. It did so by adding (as § 341(e) of the 1954 Code) an extremely complicated provision carving out four limited exceptions to the application of the statute. While we agree with petitioners that subsequent legislative developments provide little aid in interpreting an earlier statute,[22] the fact that Congress has "taken hold" of an alleged defect in the statute and provided relief much more circumscribed than that sought from the Court is surely relevant when what the Court is asked to do amounts, as here,

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[21] In 1951, the definition of a collapsible corporation was broadened to include corporations formed or availed of to purchase inventory assets. Revenue Act of 1951, § 326, 65 Stat. 452. Section 117(m) was substantially re-enacted as § 341 of the 1954 Code, but with an expansion to other categories of purchased property and to shareholders owning more than 5% of the stock. In addition, a presumption was provided as to when a corporation might be deemed collapsible. The Technical Amendments Act of 1958, § 20(a), 72 Stat. 1606, added § 341(e) to the Code, providing limited exceptions to the collapsible-corporation provisions in four situations. The latest amendment, in 1962, provided that the determinations required by § 341(e) should be made without regard to the application of § 1245(a), which provides rules for determining gain on the sale of depreciable property. Act of October 16, 1962, § 13(f)(4), 76 Stat. 960, adding § 341(e)(12).

[22] See *United States* v. *Price*, 361 U.S. 304, 313; but cf. *Great Northern Ry. Co.* v. *United States*, 315 U.S. 262, 267; *Brewster* v. *Gage*, 280 U.S. 327, 337. See also *American Automobile Ass'n.* v. *United States*, 367 U.S. 687, 694–698.

not to "interpretation" but to judicial "correction" of an alleged statutory oversight. And if nothing else, the complexity of the 1958 amendments reveals the immense difficulties inevitably encountered in implementing a "what might have been" standard of liability of the sort petitioners ask this Court to create and define quite without statutory aid.

II

THE TRANSACTION IN THIS CASE INVOLVES AN ATTEMPTED CONVERSION INTO CAPITAL GAIN OF VALUES CREATED BY THE PETITIONERS' PERSONAL EFFORTS, THE VERY ABUSE AT WHICH THE COLLAPSIBLE-CORPORATION PROVISIONS WERE AIMED

We fully agree with the proposition petitioners prove at such great length: that the basic purpose of the statute is to prevent the conversion of ordinary income into capital gain. We disagree only with what they assume: that it is necessary to rewrite the statute to conform it to that purpose and that the transaction in this case does not involve such an attempted conversion of ordinary income. We will show, contrary to petitioners' assumptions, (A) that the statute is by its own terms confined to transactions reasonably deemed by Congress to involve ordinary income conversions and (B) that the transaction in this case is a flagrant example of the abuse at which the statute was aimed. We will then show (C) that the sense in which petitioners speak of ordinary-income "conversions" in describing the purpose of the statute (by a reference to the tax consequences of one specific alternative way of con-

ducting the venture) is a highly artificial one plainly not attributable to Congress.

A. THE STATUTE'S TERMS CONFINE ITS APPLICATION TO GAINS REPRESENTING NORMAL CONSTRUCTION OR MANUFACTURING PROFITS

The statute applies, by its terms, only to corporations used for the "manufacture, construction, or production of property" and only to attempts by stockholders to realize as proceeds from stock the gain "attributable to the property so manufactured, constructed, or produced." Manufacturing, construction, and production are all endeavors by which capital and labor are employed to *create* values, and the realization upon the values so created (the only thing the statute taxes) is but the normal return for the labor and capital employed. It is a gain of a fundamentally different character from the kind of long-term appreciation in value, due to changes in market conditions, that is at least the polar example of gains for which special capital-gains taxation has traditionally been thought justified. See, *e.g., Commissioner* v. *Gillette Motor Transport,* 364 U.S. 130, 134. In § 117(m), Congress has simply made the judgment that such construction and manufacturing profits are in their "nature" ordinary income, and ought to be taxed as such rather than be allowed to be "converted" into capital gain through stock sales. That eminently sensible policy judgment provides a complete explanation both of the purpose and of the language of the statute. To confine the statute to its purpose of preventing the "conversion" of ordinary income into capital gain, the Court need only apply it as written.

B. THE GAIN REALIZED BY PETITIONERS WAS A REALIZATION, IN CONVERTED FORM, OF COMPENSATION FOR THEIR PERSONAL SERVICES

That petitioners, despite repeated assertions about the nature of their gain, never in fact examine its nature—or even allude to the facts of the transaction [23]—is perhaps understandable. For it requires only a statement of the transaction to make painfully apparent that the petitioners' gains—obliquely described by them as "resulting from a conversion of capital investment" or an "appreciation in value accrued over a substantial period of time" (Br. 23)—were but the normal profits from construction activities, a realization upon values which they themselves had created by their contributed services.

A fair arm's-length price for the construction services performed by petitioners for the corporation, as estimated by the petitioners themselves and the FHA, was $4,514,705. Petitioners, eliminating the architect's fee, the builder's fee, and the subcontractors' normal markup,[24] in fact did the work for their out-of-pocket cost of $3,807,908, a "discount" of $706,797. Had the petitioners actually charged the estimated fair price (as the "paper" contracts purported to), they would have ended up with construction profits of $706,797, taxable to them as ordinary income. By

[23] Their statement of facts is limited to a recital of the evidence which they contended below showed that they had not, during construction, contemplated "selling out," the question which, by limiting the writ, this Court declined to review.

[24] To the extent that there were also "real" savings over the estimated costs—as distinguished from the elimination of various profit elements—those too would normally go to enhance the contractor's profits rather than be passed on to the owner.

charging only the out-of-pocket costs and contributing the use of their own services and their construction organization and know-how, they were able instead to convert the "savings" into an increase in the value of their equity—*i.e.*, by creating for the corporation buildings presumably "worth" (on the FHA estimates) over $700,000 more than they cost (and, hence, more than the mortgage indebtedness to which they were subject). Then to realize their construction profits in the form of a gain from the sale of stock, they had only to find a buyer who considered the buildings to be worth their estimated fair cost, as of course they did. The $683,500 that the petitioners realized upon the disposition of their stock, far from resulting from a "conversion of capital investments" (to wit, the $30 they contributed for the stock), resulted plainly and simply from the "conversion" of the value of their contributed construction services. In a word, they took out of the corporation in the form of proceeds from the sale of stock neither more nor less than what they put into it in the form of contributed services. The receipts they claim as capital gain are but a conversion of what ought to have been (and, in an arm's-length transaction, would have been) taxed as compensation for services.

This case, then, far from involving an "unintended" application of the terms of § 117(m), is an extreme and flagrant example of the very abuse at which the statute was directed: the conversion into capital gain of the normal profits generated by the manufacture, construction, or production of property. Petitioners

are able to describe it otherwise only by a careful failure to describe it at all.

C. THAT PETITIONERS MIGHT HAVE BEEN ABLE TO CONVERT THE VALUE OF THEIR SERVICES INTO CAPITAL GAIN BY ANOTHER MEANS IS IRRELEVANT

Instead of an analysis of the transaction and of the underlying source and nature of the gain, petitioners offer as the sole determinant of whether there has been a "conversion" of ordinary income into capital gain (for purposes presumably of ascertaining the congressional purpose) a reference to what the tax consequences would have been of one particular alternative way in which the venture might have been conducted. Of the several possible transactions that would produce substantially the same economic consequences, petitioners choose as their "model"—upon the tax consequences of which the Court is asked to make the application of § 117(m) depend—one that involves a particularly great restructuring of the transaction: namely, the construction and sale of the buildings by the petitioners in their individual capacities without the use of a corporation.[23] They then assert (with no support other than cross-references to the same assertion elsewhere in their brief) that, had they conducted the venture in that form, their gain would have been taxed only as capital gain. Since the tax consequences of that chosen model must, for some unexplained reason, be taken as establishing the

[23] In fact, petitioners stated in the court of appeals (Reply Br. 4) that the FHA required the use of a corporation for any mortgage in excess of $200,000. If so, they could not in fact have conducted the enterprise as individuals.

"true" nature of the gain, it follows that the government is attempting to pervert the statute by applying it "so as to produce a conversion of capital gain into ordinary income" (Br. 95).[26]

There are two basic fallacies in the unstated premises of petitioners' argument. The first unsupportable premise is that, in adopting § 117(m), Congress chose not to make its own policy judgment of the kinds of gain that "ought" to be taxed as ordinary income and not be allowed to be "converted" into capital gains by stock sales, but rather decided to make the statute's application dependent upon a judicial determination in each case of how the transaction would have been taxed had it been conducted in some other way. Not only is that an unusual way for Congress to act, but the detailed prescription in § 117(m) of the transactions to which it is to apply makes the premise specious on its face.

Second, even assuming Congress meant to leave the operation of its statute dependent in each case upon a judicial characterization of the underlying gain, what possible reason is there why the characterization should be determined solely by the tax consequences of the particular hypothetical alternative transaction that the taxpayers choose to offer as a model? The model petitioners offer (construction and sale as in-

[26] The government's action, indeed, is not merely erroneous; it "violates the standards of responsible tax administration" and raises fundamental questions going "to the very essence of tax administration in our democratic society" and casting in doubt "no less than the integrity of the administrative process in our tax system." Pet. Br., Pt. VI, pp. 94-102.

dividuals) is not the only alternative way of achieving the same economic results nor even the closest one (in the sense of involving the least restructuring). The closest model is the one petitioners themselves set up "on paper"—to wit, the payment by the corporation to them of a full arm's-length price for their construction services. That, indeed, involves no basic restructuring at all, but simply the elimination of the non-arm's-length element from the dealings between the corporation and the partnership controlled by the same persons. And, of course, if an arm's-length version of the actual transaction were to be chosen as the model, it would reveal the obvious truth that the gain petitioners realized was in fact nothing more than an indirect realization of the value of their construction services.

In the end, petitioners' entire argument reduces itself to a play upon words, the key to which is the very specialized meaning they insinuate into the phrase "conversion of ordinary income into capital gain." Such catchwords are capable of being given many meanings, but surely the usual meaning, at least in the context of discussions of basic statutory policy, is quite different from petitioners' usage. The phrase rather presupposes the existence of a rational policy distinction between the elements of economic gain that should be (and generally are) taxed as ordinary income and those that should be (and generally are) taxed as capital gain. If that which should be taxed as ordinary income under the basic rationale is realized in such a way ~~that~~ it in fact obtains capital-gains treatment, the departure from the norm is de-

scribed as a "conversion of ordinary income into capital gain." To a large extent, the reference is to the "ought" and, to the extent that it is to the "is", it is to the way in which the basic elements of the gain are *generally* treated for tax purposes, not to the outcome of a single, particularized, hypothetical transaction. The return from the performance of personal services, for example, is *generally* taxed as ordinary income; and if in some cases values which a taxpayer has created by his personal efforts are allowed to be taxed as capital gain, the result is commonly, and fairly, described as a "conversion of ordinary income into capital gain." And that is an equally valid description whether or not there is more than one way in which the "conversion" might be accomplished.

Thus the fact, if true (but see notes 27–28, *infra*), that the petitioners could have converted their construction profits into capital gain by conducting the venture as individuals proves nothing. It means only that there still exist other means by which the fruits of one's personal labor, generally taxed as ordinary income, may be "converted" into capital gain. In the case of individuals creating property for use by themselves, there may of course be sufficient reasons of policy, or of practicality, for tolerating the element of ordinary-income "conversion" involved,[27] but that plainly affords no reason why

[27] The main obstacle seems to be the problem of "realization" combined with the difficulty of apportioning a single gain into its several elements. If an individual devotes his labor to build a house, he has created values from his personal services which in principle should be taxed as ordinary income. If he does not immediately sell the house, however, there is at that

Congress should tolerate the use of corporations with a specific view to exploiting such "conversion" possibilities. Whatever the result in the hypotheti-

point no "realization" of the values. And when later he does sell the house, there is no easy way to distinguish between the proceeds representing a realization upon the values originally created by his efforts and those attributable to long-term appreciation during the period of his holding. The admittedly imperfect, but practical, solution that has been adopted is to treat the gain all or none as capital gain depending generally upon the taxpayers' purpose in creating and holding the property. To use only polar examples, the property is treated as a capital asset if it was created and held solely for self-use or rental purposes without thought of sale but not if it was created and held solely for the purpose of sale. The precise dividing line is, of course, a difficult question and one on which the law is in a state of flux. See, in particular, *Rollingwood Corp.* v. *Commissioner*, 190 F. 2d 263, 266 (C.A. 9); *Pacific Homes, Inc.* v. *United States*, 129 F. Supp. 796 (N.D. Cal.), affirmed, 230 F. 2d 755 (C.A. 9).

It is interesting to speculate whether the above cases are not the beginnings of a judicial recognition that taxpayer-created properties pose problems quite different from those of purchased properties and the development for the former of standards closely similar to those of § 117(m)—i.e., created property is not a capital asset if sale was contemplated during construction as one of the substantial possible alternatives and the property was in fact sold quite soon after construction. Although the general definitions of a "capital asset" (§ 117(a)(1)) (or of what amounts to the same thing for present purposes, "property used in the trade or business", § 117(j)) do not allude to the difference between purchased and created properties, those definitions are admittedly so general that the articulation of the precise dividing lines has necessarily been left to the courts. See, *e.g.*, *Commissioner* v. *Gillette Motor Transport*, 364 U.S. 130; *Commissioner* v. *Lake*, 356 U.S. 260. And in the case of certain types of created properties where the "conversion" of ordinary income is particularly extreme—copyrights, books, musical or artistic compositions and the like, properties which are almost entirely the product of personal

cal case petitioners offer as a model,[28] the fact remains that the gain they realized upon the sale of the stock was attributable entirely to values created by the construction services they contributed to the corporation. And the use of a corporation to effect such a conversion of the value of personal services (or, more generally, values created in the construction process) into the proceeds of a stock sale was the very

efforts and requiring little, if any, capital investment—Congress has taken the extreme step of denying capital-gains treatment to the creator regardless of how long or for what purpose he holds the property. See § 117(a)(1)(C); H. Rep. No. 2319, 81st Cong., 2d Sess., pp. 54, 92-93; S. Rep. 2375, 81st Cong., 2d Sess., pp. 43-44, 83-84. That that provision was added at the same time as § 117(m) confirms the primary concern of Congress with the conversion of "created" values into capital gain.

[28] The question is a difficult one, not only because the law applicable to construction and sale by individuals is unclear and in a state of evolution (see note 27, *supra*), but because it is unclear exactly what assumptions are to be made in stating petitioners' hypothetical question. What precisely, for example, is to be assumed about the state of mind they would have had had they acted as individuals? The transfer of attitudes necessarily formed with respect to the existence and use of the corporate form to an assumed transaction in which there is no corporation is no small feat. For another example of the difficulties, what is to be assumed about the petitioners' other construction ventures conducted through other corporations: if Springfield is to be assumed away, are the other corporate entities likewise to be ignored? For the complex treatment of the latter problem found necessary by Congress when it undertook to give relief of the nature petitioners seek, see § 341(e) of the 1954 Code. Because of all those difficulties, we have made no effort here to answer petitioners' hypothetical question. Should it prove to be relevant, it would be necessary in any event to remand the case to the Tax Court for it to determine the question in the first instance.

kind of "conversion of ordinary income into capital gain" at which the statute was specifically directed.[29]

III

THE LEGISLATIVE HISTORY SHOWS THAT THE PRIMARY OBJECT OF THE STATUTE WAS A TRANSACTION IDENTICAL IN ALL ESSENTIAL ELEMENTS TO THE TRANSACTION IN THIS CASE

The enactment of § 117(m) was prompted by a specific tax abuse prevalent in the making of motion pictures. The offending transaction was described in detail in the committee reports[30] but its essence

[29] We may note, finally, that even if petitioners are right about the tax treatment they would have received as individuals, this would not be the first time that persons using the corporate form have had to accept the tax consequences of their choice. See, *e.g.*, *Moline Properties* v. *Commissioner*, 319 U.S. 436.

[30] H. Rep. No. 2319, 81st Cong., 2d Sess., pp. 56–57; S. Rep. No. 2375, 81st Cong., 2d Sess., p. 45:

"The collapsible corporation is a device which has been used in an attempt to convert ordinary income into long-term capital gain by use of a temporary corporation. The device has been used principally in the motion-picture industry. A legitimate corporation engaged in the business of producing motion pictures would pay ordinarily the corporate income tax on its net income and its shareholders would pay ordinary income tax on their dividends from the corporation. Producers have tried to avoid these results by organizing separate corporations for each motion picture. Upon completion of the film but prior to the realization by the corporation of any income therefrom, the corporation is liquidated and the assets are distributed. In such a case, the corporation pays no tax, claiming that it has realized no income. The producer pays tax upon the difference between his cost and the fair market value of the assets so distributed: but such gain is reported as long-term capital gain with a maximum effective rate of 25 percent. After liquidation, the fair

was given in President Truman's recommendation to Congress (Hearings before House Committee on Ways and Means on Revenue Revision of 1950, 81st Cong., 2d Sess., p. 5):

> * * * As one example, under present law producers of motion pictures, and their star players, have attempted to avoid taxes by creating temporary corporations which are dissolved after making one film. By this device, their income from making the film, which ought to be taxed at the individual-income tax rates, would be taxed only at the capital-gains rate. * * *

Our purpose is to demonstrate that the apartment-building transaction in this case is an identical twin to the movie-making transaction that prompted the statute.

In the proscribed movie-making transaction, a producer and actors form a corporation, contribute their services to it for the making of a movie, and liquidate the corporation when the movie is finished. Upon liquidation, they are taxed on the value of the movie as capital gain. That taxed value then becomes their basis in the movie which they may recover tax-free from the proceeds of leasing or selling it. Alternatively, the stockholders could simply sell the stock

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market value of the released production is ordinarily amortized against the income from the film as it is received. If the income from the film does not exceed such fair market value, there is no further tax.

"In addition to the motion-picture industry, it is understood that the collapsible-corporation device has also been used in the building-construction trade by contractors who have corporations construct buildings for sale and then liquidate the corporations and sell the buildings as individuals."

after the movie was completed,[31] leaving it to the buyer to liquidate and transfer his cost basis to the movie. Either way, the difference between the cost of the movie and its value on completion is taxed solely as capital gain.

The basic abuse of that transaction is the conversion of the values created in producing the movie, through the stockholders' contributed services, into capital gain. Had the corporation been allowed to exploit the movie, those values would ultimately have been realized as ordinary rental income, since the corporation could offset (amortize) only the actual costs against the rental income. The prompt "collapsing" of the corporation prevents that ordinary-income realization of the created values and "converts" them into capital gain.

Moving from that aboriginal example of the "collapsible corporation" to this case, it is evident that only the locale and the cast of characters have been changed. Apartment buildings have been substituted for movies and architects and builders for producers and actors, but the scenario is otherwise the same. The values are created in the same way (by the contributed services of the stockholders) and realized in the same way (by liquidation or sale of the stock). In neither case is compensation paid for the services and in neither case is the corporation allowed to realize the created values by converting them into ordinary rental income. In both cases, if the stockholders liqui-

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[31] The statute plainly makes nothing turn on whether the corporation is liquidated or the stock sold. See § 117(m)(1), (2)(A)(i); see also H. Rep. No. 2319, *supra*, p. 97.

date the corporation they will receive (in exchange for only a capital gains tax) a new basis to amortize or depreciate against the rental receipts; and if they sell the stock the buyer can transfer his basis to the assets by a subsequent liquidation. In short, to the last significant detail, the transactions are identical.[32]

To conclude the matter, it needs to be added only that, prior to the 1950 act, individuals making a movie purportedly for rental purposes and then selling it could have made precisely the same claim to capital-gains treatment that petitioners make for their hypothetical transaction (*i.e.*, individuals construct-

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[32] Petitioners, to avoid the impact of the movie example, draw a distinction between liquidations and stock sales, arguing in effect that movie-making corporations can still be "collapsed" with capital-gains treatment, notwithstanding § 117(m), if only the actors and producers, upon completion of the movie, take care to sell their stock rather than liquidate the corporation (Br. 69–76). For all the acclaim with which it would be received in Hollywood, the distinction is as lacking in economic reality as it is in statutory support (see note 31, *supra*). If a corporation has created a movie worth $1,000,000, the stockholders can realize its value either by selling their stock for $1,000,000 or by distributing the movie to themselves in liquidation (thereafter either selling it for $1,000,000 or recovering its $1,000,000 value out of rental proceeds). The gain realized by the two routes, far from being "distinctly unlike" (Pet. Br. 71), is identical in source and nature; in either case it is the direct realization by the stockholders of the values created by the movie's production. And even the surface distinction between liquidations and stock sales evaporates when it is recognized that the purchaser of the stock (in stock sales) is free immediately to liquidate the corporation, while the stockholders receiving the property (in liquidations) are free immediately to sell it. The two routes thus not only produce the same gain for the stockholders but may produce identical end results even for the purchaser.

ing a building purportedly for rental purposes and then selling it). Thus, even assuming petitioners to be right on the merits of that claim, it is evident that Congress did not take the tax treatment of individuals in a particular alternative transaction as the determinant either of the application of its new statute or of what it meant by the criticized "conversion" of ordinary income.[33] To put the matter most bluntly, for petitioners to prevail the Court would have to hold no less than that § 117(m) did not by its terms apply to the case that prompted its enactment.

CONCLUSION

We have emphasized the facts of this case—in particular, the origin of petitioners' gains in their contribution of services—only because of petitioners' insistence that, despite the literal applicability of the statutory language, the case does not involve the kind of transaction to which Congress "intended" § 117 (m) to apply. Quite to the contrary, we have shown, the actual facts present in exaggerated form the most

[33] Although the committee reports on § 117(m) do not allude to the fact, we note that another provision of the same act (§ 210(a), Revenue Act of 1950, 64 Stat. 932) amended the definition of a capital asset to exclude "a copyright; a literary, musical, or artistic composition; or similar property; held by * * * a taxpayer whose personal efforts created such property" (§ 117(a)(1)(C)). At least in some situations, that provision might well apply to a motion-picture made by an individual, and to that extent remove the parallelism after 1950 between individual apartment-building and individual movie-making. Nothing in the history, however, suggests that Congress' purpose in § 117(m) to proscribe the corporate abuse typified by the movie example was derived from or dependent upon the amendments to the "capital asset" definition.

blatant kind of abuse at which the statute was aimed: the conversion, as in the movie example, of contributed personal services into the proceeds of stock. In closing, however, it is important to reemphasize what is of the essence and what is not. By its terms, the statute is concerned generally with the conversion of values generated by the "manufacture, construction, or production of property," and the specific identity of the factors primarily responsible for the values created in those processes (capital, labor, know-how, sound market analysis, or whatever) is ultimately immaterial. The stockholders' contribution of services to the process may dramatically increase the resulting excess of value over cost and thereby highlight the abuse, but the statute reaches all gains "attributable to the property so manufactured, constructed, or produced" regardless of whether they represent only the normal profits of manufacturing and construction (the values added simply by combining the necessary factors of production to create an economically useful product) or, as here, profits artificially inflated by the contribution of services.

The surest guide to the intended scope of the statute is its own terms, and what should be ultimately controlling here, therefore, is not the fact, though true and revealing the extent of the abuse, that the gains can be traced back to the contributed personal services of the petitioners. What should control, quite simply, is that the corporation was used "for the manufacture, construction, or production of property" (§ 117(m)(2)(A)) and the gain sought and realized by the contemplated stock sale was "gain

* * * attributable to the property so manufactured, constructed, or produced" (§ 117(m) (3)(B), (2)(A)(ii)). By limiting the gain it taxes as ordinary income to that representing values added in the income-producing processes of "manufacture, construction, or production,"[34] the statute executes in precise degree its purpose to prevent the "conversion of ordinary income into capital gain." To confine it to that purpose, no judicial exegesis is needed.

For the reasons stated, the judgment of the court of appeals should be affirmed.

Respectfully submitted.

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MARCH 1963.

[34] See H. Rep. No. 2319, *supra*, p. 98, and S. Rep. No. 2375, *supra*, p. 90, explaining why the statute was drawn to include a corporation which engaged in the manufacture, construction, or production of property "to any extent" (§ 117(m)(2)(B)(i)) even though it neither began nor completed the process: "It will nonetheless be deemed to have manufactured, constructed or produced property in that its shareholders may realize gain with respect to the additional value added to the property by the manufacture, construction or production to the extent that it was carried out."

APPENDIX

Internal Revenue Code of 1939

Sec. 117. Capital Gains and Losses.

* * * * *

(m) [As added by Revenue Act of 1950, § 212(a), 64 Stat. 906] *Collapsible Corporations.*—

(1) *Treatment of gain to shareholders.*—Gain from the sale or exchange (whether in liquidation or otherwise) of stock of a collapsible corporation, to the extent that it would be considered (but for the provisions of this subsection) as gain from the sale or exchange of a capital asset held for more than 6 months, shall, except as provided in paragraph (3), be considered as gain from the sale or exchange of property which is not a capital asset.

(2) *Definitions.*—

(A) For the purposes of this subsection, the term "collapsible corporation" means a corporation formed or availed of principally for the manufacture, construction, or production of property, or for the holding of stock in a corporation so formed or availed of, with a view to—

(i) The sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, or producing the property of a substantial part of the net income to be derived from such property, and

(ii) the realization by such shareholders of gain attributable to such property.

(B) For the purposes of subparagraph (A), a corporation shall be deemed to have manufactured, constructed, or produced property, if—

(i) it engaged in the manufacture, construction, or production of such property to any extent,

(ii) it holds property having a basis determined, in whole or in part, by reference to the cost of such property in the hands of a person who manufactured, constructed, or produced the property, or

(iii) it holds property having a basis determined in whole or in part, by reference to the cost of property manufactured, constructed, or produced by the corporation.

(3) *Limitations on application of subsection.*—In the case of gain realized by a shareholder upon his stock in a collapsible corporation—

(A) this subsection shall not apply unless, at any time after the commencement of the manufacture, construction, or production of the property, such shareholder (i) owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation, or (ii) owned stock which was considered as owned at such time by another shareholder who then owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation;

(B) this subsection shall not apply to the gain recognized during a taxable year unless more than 70 per centum of such gain is at-

tributable to the property so manufactured, constructed, or produced; and

(C) this subsection shall not apply to gain realized after the expiration of three years following the completion of such manufacture, construction, or production.

For purposes of subparagraph (A), the ownership of stock shall be determined in accordance with the rules prescribed by paragraphs (1), (2), (3), (5), and (6) of section 503(a), except that, in addition to the persons prescribed by paragraph (2) of that section, the family of an individual shall include the spouses of that individual's brothers and sisters (whether by the whole or half blood) and the spouses of that individual's lineal descendants.

TREASURY REGULATIONS 111 (1939 CODE)

SEC. 29.117-11 [as added by T.D. 5999, 1953-1 Cum. Bull. 187]. *Collapsible Corporations.—(a) In general.*—With respect to taxable years ending after December 31, 1949, but only with respect to gain realized after such date, and subject to the limitations contained in (c) hereof, the entire gain from (1) the actual sale or exchange of stock of a collapsible corporation, (2) amounts distributed in complete or partial liquidation of a collapsible corporation which are treated, under section 115(c), as payment in exchange for stock, and (3) a distribution made by a collapsible corporation which, under section 115(d), is treated, to the extent it exceeds the basis of the stock, in the same manner as a gain from the sale or exchange of property, shall be considered as gain from the sale or exchange of property which is not a capital asset.

(b) *Determination of collapsible corporation.*—With respect to taxable years ending after December

31, 1949, but only with respect to gain realized after such date, a collapsible corporation is defined by section 117(m)(2)(A) to be a corporation formed or availed of principally for the manufacture, construction, or production of property, or for the holding of stock in a corporation so formed or availed of, with a view to (1) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, or producing the property of a substantial part of the net income to be derived from such property, and (2) the realization by such shareholders of gain attributable to such property. * * *

* * * * *

Under section 117(m)(2)(A), the corporation must be formed or availed of with a view to the action therein described, that is, the sale or exchange of its stock by its shareholders, or a distribution to them, prior to the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the net income to be derived from such property, and the realization by the shareholders of gain attributable to such property. This requirement is satisfied in any case in which such action was contemplated by those persons in a position to determine the policies of the corporation, whether by reason of their owning a majority of the voting stock of the corporation or otherwise. The requirement is satisfied whether such action was contemplated unconditionally, conditionally, or as a recognized possibility. * * *

A corporation is formed or availed of with a view to the action described in section 117(m)(2)(A) if the requisite view existed at any time during the

manufacture, production, construction, or purchase referred to in that section. * * *

The property referred to in Section 117(m)(2)(A) is that property or the aggregate of those properties with respect to which the requisite view existed. In order to ascertain the property or properties as to which the requisite view existed, reference shall be made to each property as to which, at the time of the sale, exchange, or distribution referred to in section 117(m)(2)(A), there has not been a realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the net income to be derived from such property. * * *

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(c) *Limitations on application of section.*—* * * (3) *Seventy-percent rule.*—This section shall apply to the gain recognized during a taxable year upon the stock in a collapsible corporation only if more than 70 percent of such gain is attributable to the property referred to in section 117(m)(2)(A). If more than 70 percent of such gain is so attributable, then all of such gain is subject to this section, and, if 70 percent or less of such gain is so attributable, then none of such gain is subject to this section.

For the purpose of this limitation, the gain attributable to the property referred to in section 117(m)(2)(A) is the excess of the recognized gain of the shareholder during the taxable year upon his stock in the collapsible corporation over the recognized gain which the shareholder would have if the property had not been manufactured, constructed, produced, or purchased. In the case of gain on a distribution in partial liquidation or a distribution described in section 115(d), the gain attributable to the property shall not be less than an amount

which bears the same ratio to the gain on such distribution as the gain which would be attributable to the property if there had been a complete liquidation at the time of such distribution bears to the total gain which would have resulted from such complete liquidation.

Gain may be attributable to the property referred to in section 117(m)(2)(A) even though such gain is represented by an appreciation in the value of property other than that manufactured, constructed, produced, or purchased. Where, for example, a corporation owns a tract of land and the development of one-half of the tract increases the value of the other half, the gain attributable to the developed half of the tract includes the increase in the value of the other half.

(4) *Three-year rule.*—This section shall not apply to that portion of the gain of a shareholder that is realized more than 3 years after the actual completion of the manufacture, construction, production, or purchase of the property to which such portion is attributable.

(d) *Application of section.*—(1) Whether or not a corporation is a collapsible corporation shall be determined under the rules of (*b*) of this section on the basis of all the facts and circumstances in each particular case. The following paragraphs set forth those facts which will ordinarily be considered sufficient to establish that a corporation is or is not a collapsible corporation. The facts set forth in the following paragraphs are not exclusive of other facts which may be controlling in any particular case. * * *

* * * * *

(2) The following facts will ordinarily be considered sufficient (except as otherwise provided in paragraph (1), above, and paragraph (3), below)

to establish that a corporation is a collapsible corporation:

(i) A shareholder of the corporation sells or exchanges his stock, or receives a liquidating distribution, or a distribution described in section 115(d),

(ii) Upon such sale, exchange or distribution, such shareholder realizes gain attributable to the property described below, and

(iii) At the time of the manufacture, construction, production, or purchase of the property described below, such activity as substantial in relation to the other activities of the corporation which manufactured, constructed, produced, or purchased such property.

The property referred to above is that property or the aggregate of those properties which meet the following two requirements:

(iv) The property is manufactured, constructed, or produced by the corporation * * *, and

(v) At the time of the sale, exchange, or distribution described in (i) above, the corporation which manufactured, constructed, produced, or purchased such property has not realized a substantial part of the net income to be derived from such property.

In the case of property which is a unit of an integrated project involving several properties similar in kind, the rules of this paragraph shall be applied to the aggregate of the properties constituting the single project rather than separately to such unit. * * *

* * * * *

(e) *Examples.*—The following examples will illustrate the application of this section:

Example (*1*). On January 2, 1951, A formed the W Corporation and contributed $50,000 cash in exchange for all of the stock thereof. The W Corporation borrowed $900,000 from a bank, the loan being insured by the Federal Housing Authority, and used $800,000 of such sum in the construction of an apartment house on land which it purchased for $50,000. The apartment house was completed on December 31, 1951. On December 31, 1951, the corporation, having determined that the fair market value of the apartment house, separate and apart from the land, was $900,000, made a distribution (permitted under the applicable state law) to A of $100,000. At this time, the fair market value of the land was $50,000. As of December 31, 1951, the corporation has not realized any earnings and profits. In 1952, the corporation began the operation of the apartment house and received rentals therefrom. The corporation has since continued to own and operate the building. The corporation reported on the basis of the calendar year and cash receipts and disbursements.

Since A received a distribution and realized a gain attributable to the building constructed by the corporation, since, at the time of such distribution, the corporation has not realized a substantial part of the net income to be derived from such building, and since the construction of the building was a substantial activity of the corporation, the W Corporation is considered a collapsible corporation under (*d*)(2) of this section. The provisions of section 117(m)(3) do not prohibit the application of section 117(m)(1) to A. Therefore, the distribution, if and to the extent that it may be considered long-term capital gain rather than ordinary income without regard to section 117(m), will be considered ordinary income under section 117(m)(1).

In the event of the existence of additional facts and circumstances in the above case, the corporation, notwithstanding the above facts, might not be considered a collapsible corporation. See (*b*) and (*d*)(1) of this section.

Example (2). On January 2, 1950, B formed the X Corporation and became the sole shareholder thereof. This corporation completed the construction of an office building in 1950. Immediately after the completion of the building, the corporation sold this building at a gain of $50,000, included this entire gain in its return for 1950, and distributed this entire gain (less taxes) to B. The corporation completed the construction of a second office building in June 1951. In August 1951, B sold the entire stock of the X Corporation at a gain of $12,000, which gain is attributable to the second building. In view of the fact that B sold stock of the X Corporation and realized a gain attributable to the second office building, that, at the time of such sale, the corporation had not realized a substantial part of the net income to be derived from such building, and that the construction of such building during the time of such construction was a substantial activity of the corporation, the X Corporation is considered a collapsible corporation under (*d*)(2) of this section. Since the provisions of section 117(m)(3) do not prohibit the application of section 117(m)(1) to B the gain of $12,000 to B is, accordingly, considered ordinary income.

Example (3). The facts in this example are the same as in example (2), except that the following facts are shown: B was the president of the X Corporation and active in the conduct of its business. The second building was constructed as the first step in a project of the X Corporation for the development for rental purposes of a large suburban center involv-

ing the construction of several buildings by the corporation. The sale of the stock by B was caused by his retiring from all business activity as a result of illness arising after the second building was constructed. Under these additional facts, the corporation is not considered a collapsible corporation. See (*b*) and (*d*)(1) of this section.

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